# MACROECONOMIC PROJECTIONS FOR THE SPANISH ECONOMY (2019-2021): THE BANCO DE ESPAÑA'S CONTRIBUTION TO THE EUROSYSTEM'S JUNE 2019 JOINT FORECASTING EXERCISE

## Introduction and summary

This note describes the macroeconomic projections for the Spanish economy for the period 2019-2021, which are part of the projections for the euro area as a whole published by the ECB on 6 June.[1] The current projections for Spain incorporate the information that has come to light since the publication of the previous projections on 20 March in *Economic Bulletin* 1/2019.[2]

In 2019 to date, activity in the Spanish economy has remained notably robust. Specifically, on initial INE estimates, GDP grew at a quarter-on-quarter rate of 0.7% in 2019 Q1, slightly up on what was expected in March and on the previous quarters. The buoyancy of activity in Q1 thus continued to be greater than that observed in the euro area as a whole, where there was also an upward surprise in GDP growth: it stood at 0.4%, 0.2 pp up on end-2018. In Q2, output growth in the Spanish economy may, according to the information available, be estimated to be around 0.6% (set against the somewhat greater slowdown in the euro area as a whole).

The present projections point to a prolongation of the current upturn over the time horizon considered. Underpinning this outlook is the fact that the sustained growth of output and of employment is proving compatible with the maintenance of a set of macrofinancial equilibria. These include most notably a favourable competitive position, which has enabled recurrent current account surpluses to be run in recent years, and the strengthening at the aggregate level of the balance sheet position of private agents, financial and non-financial alike. These factors will continue supporting the current expansionary dynamics. And also contributing will be the maintenance of an accommodative monetary policy stance and the assumption that export markets, following their recent weakening and in the absence of new adverse developments, will continue gradually to pick up in the coming quarters. As a result, the economy's growth rate is expected to continue comfortably to exceed its potential rate, which will enable it to carry on re-absorbing the still-high level of unemployment.

However, GDP growth is forecast to move on a gradually slowing path over the projection horizon. Among other factors, that will be the consequence of the progressive slackening of the expansionary effects of the monetary policy measures adopted in recent years, meaning that financing conditions, while easy, will see their positive impact on output growth gradually diminish. In respect of demand-side policies, in accordance with the assumptions included on the fiscal policy stance, mention may be made of the expansionary effect of the budgetary policy measures adopted in 2018. In particular, these gave added momentum to household income, and this impact will tend to tail off over the course of 2019. Lastly, the National Accounts information on private consumption in 2018 Q4 and 2019 Q1, along with the slowdown observed in recent months in lending for consumer spending, suggests that households might be tempering the rate of expansion of their demand for goods and services. This trend might auger a certain rise in the household

1 See the Eurosystem staff macroeconomic projections for the euro area. June 2019.

2 Specifically, compared with the Macroeconomic projections for Spain (2019-2021), published as Box 1 in the "Quarterly Report on the Spanish Economy" in *Economic Bulletin* 1/2019, the current projections include the changes observed from 7 March to 15 May in the technical assumptions, in the budgetary assumptions and in the projections for the Spanish economy's external setting. Moreover, the projections include the QNA preliminary estimates for 2019 Q1.

MACROECONOMIC PROJECTIONS FOR THE SPANISH ECONOMY (a) — TABLE 1

Annual rate of change in volume terms and % of GDP

| | | June 2019 projections | | | Changes from March 2019 projections | | |
|---|---|---|---|---|---|---|---|
| | 2018 | 2019 | 2020 | 2021 | 2019 | 2020 | 2021 |
| GDP | 2.6 | 2.4 | 1.9 | 1.7 | 0.2 | 0.0 | 0.0 |
| Private consumption | 2.3 | 1.8 | 1.7 | 1.5 | -0.2 | 0.0 | 0.1 |
| Government consumption | 2.1 | 1.7 | 1.3 | 1.2 | -0.1 | 0.0 | 0.0 |
| Gross fixed capital formation | 5.3 | 4.1 | 3.9 | 2.8 | 0.2 | 0.1 | 0.2 |
| Investment in equipment, intangibles and other (b) | 4.3 | 3.7 | 3.5 | 2.5 | 0.5 | 0.2 | 0.4 |
| Investment in construction | 6.2 | 4.6 | 4.3 | 3.1 | 0.0 | -0.1 | 0.0 |
| Exports of goods and services | 2.3 | 1.6 | 3.2 | 3.5 | -1.6 | -0.8 | -0.2 |
| Imports of goods and services | 3.5 | 1.4 | 3.8 | 3.6 | -2.2 | -0.8 | -0.3 |
| National demand (contribution to growth) | 2.9 | 2.3 | 2.1 | 1.7 | 0.0 | 0.1 | 0.0 |
| Net external demand (contribution to growth) | -0.3 | 0.1 | -0.2 | 0.0 | 0.2 | 0.0 | 0.0 |
| Nominal GDP | 3.6 | 3.3 | 3.7 | 3.6 | -0.4 | 0.1 | 0.1 |
| GDP deflator | 1.0 | 0.9 | 1.7 | 1.8 | -0.5 | 0.1 | 0.0 |
| Harmonised index of consumer prices (HICP) | 1.7 | 1.1 | 1.3 | 1.5 | -0.1 | -0.2 | -0.1 |
| HICP excluding energy and food | 1.0 | 1.2 | 1.5 | 1.7 | 0.1 | 0.0 | 0.0 |
| Employment (full-time equivalent jobs) | 2.5 | 2.0 | 1.6 | 1.6 | 0.4 | 0.0 | 0.0 |
| Unemployment rate (% of labour force). End-of-period data | 14.4 | 13.8 | 12.4 | 11.8 | -0.1 | -0.4 | -0.3 |
| Unemployment rate (% of labour force). Annual average | 15.3 | 13.9 | 13.0 | 12.1 | -0.3 | -0.2 | -0.2 |
| Net lending (+)/net borrowing (–) of the nation (% of GDP) | 1.5 | 1.0 | 0.9 | 0.9 | -0.1 | 0.1 | 0.2 |
| General government net lending (+)/net borrowing (–) (% of GDP) | -2.5 | -2.4 | -1.8 | -1.6 | 0.1 | 0.2 | 0.2 |

SOURCES: Banco de España and INE.
Latest QNA figure published: Q1 2019.

**a** Projections cut-off date: 22 May 2019.
**b** Includes machinery, capital goods, weapons systems, cultivated biological resources and intellectual property products.

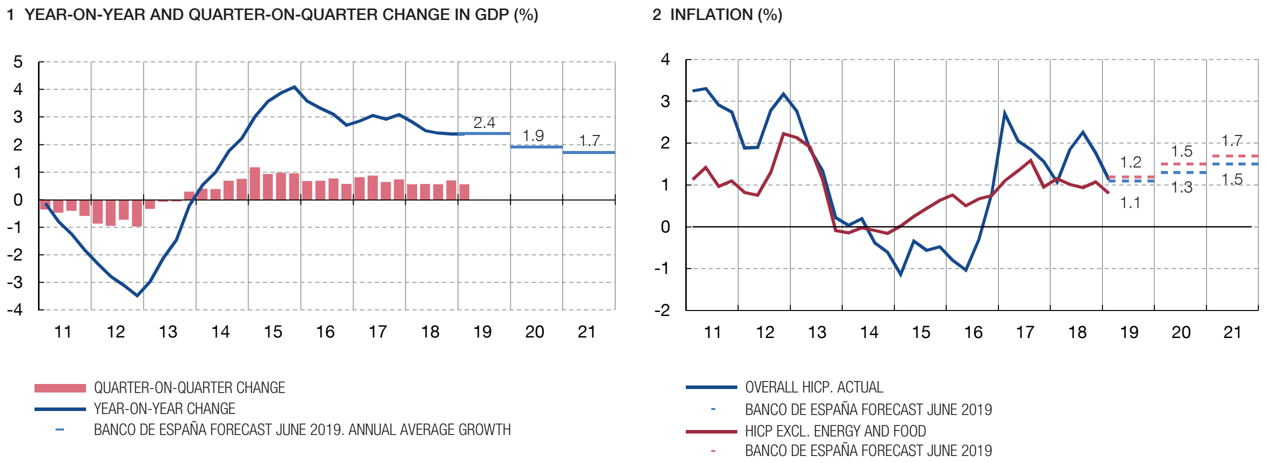
saving rate, which currently stands at a historical low. Also contributing to this somewhat less dynamic behaviour, not only of consumer spending but also of investment by households and firms, is a continuing high degree of global uncertainty. The upshot is that the increase in GDP, after running at 2.6% in 2018, will ease to 2.4% in 2019, 1.9% in 2020 and 1.7% in 2021 (see Table 1 and Chart 1).

Turning to prices, the gradual widening of the positive output gap further to the continuation of the upturn is expected to translate into a progressive rise over the projection horizon in core inflation. On average, the Harmonised Index of Consumer Prices (HICP), which excludes food and energy goods, will post increases of 1.2%, 1.5% and 1.7%, respectively, in 2019, 2020 and 2021. The rising trajectory of prices will be less pronounced in terms of the overall HICP. That is due to the declining path which – according to the oil price assumptions made on the basis of the path of futures market prices for this commodity – the rate of change of the energy component is expected to follow, turning negative in the two years spanning 2020 and 2021.

Compared with the March projections, GDP growth has been revised slightly upwards in 2019. This is as a result, first, of the fact that the rate for Q1, as noted, was 0.1 pp up on

GROWTH AND INFLATION OUTLOOK FOR SPAIN

CHART 1




SOURCES: INE and Banco de España.

that projected three months earlier; and further, of the 0.1 pp improvement in the projection for Q2, in light of the latest data on activity. Both for the second half of 2019, and for the two following years, the GDP growth path will hold unchanged. This is the net outcome of various changes of the opposite sign in the assumptions on which the projections are based. On one hand, the projected loss of momentum of exports markets and the higher level of oil prices are now somewhat less favourable for output growth. Countering this, somewhat lower financing costs are anticipated, in step with the expected lower level of interest rates, according to financial markets prices.

The projections relating to core inflation have undergone practically no revision, in line with the absence of significant changes in the outlook for activity and the labour market. However, the HICP growth projections are now slightly down on those for March throughout the forecasting horizon, owing to the lower growth rates of the energy component. In the short term, this is related to the recent downward surprises in gas and electricity prices, and in the medium term, to the more marked decline in oil prices anticipated by the futures markets.

## Activity and employment

From the standpoint of the composition of aggregate demand, output growth will continue to be underpinned by the buoyancy of private domestic spending. Assisting this latter variable will be the healthier financial position of households and firms, and the continuation of very favourable financial conditions. Specifically, the current projections point to the very high persistence of the low cost of credit financing; conversely, however, the latest information suggests the emergence of some incipient signs of a tightening of lending standards. The contribution of net external demand to the expansion of output is expected, on average, to be approximately zero throughout the projection period, against the backdrop of somewhat sluggish external markets.

Among the various national demand components, private consumption is expected to continue posting sustained growth over the forecasting horizon. The reasons for this are the continuing expansionary behaviour of household labour income, relief for the financial burden of the most indebted households as a result of the persistently low levels of interest rates, and the favourable course of real household wealth, against a background in which house prices continue to move on a rising path. Yet as the latest information has begun to suggest, the buoyancy of this aggregate expenditure component will tend to ease gradually relative to its recent course, owing to the confluence of several factors.

Firstly, although household labour income will continue to grow in the near future, the increase will tend to rest more on the pick-up in real wages than on net job creation, unlike in recent years. A priori, this composition of labour income growth is less conducive to increases in consumption, given that the marginal propensity to spend is lower when the rise in labour income stems from higher real wages than when its origin lies in an increase in employment. Secondly, the projections include the assumption that, in a setting of high global uncertainty, households will tend to rebuild their saving rate, which is currently at a historical low. In this respect, the slowdown in consumer lending since late 2018 might reflect some easing in the propensity to spend against future income; but it might also have to do, at least partly, with transitory factors, such as those linked to recent developments in the car market.[3] Thirdly, the projected easing in consumption is also underpinned by the tailing off of the process whereby the pent-up demand for durable and semi-durable goods that built up during the crisis has progressively been met in recent years. Lastly, the impulse to household income provided by the 2018 State Budget, whose effects are still being felt at present, will tend to fade beyond the short term. The resulting path of private consumption includes a slight downward revision in the short term, induced by the latest information, and it shows no significant changes in the rest of the projection horizon.

As regards the components of gross fixed capital formation, residential investment will continue to be spurred by the favourable behaviour of the labour market and by the persistence of benign financing conditions. This demand component experienced high growth rates in the initial years of the recovery, after having reached a very low level in the wake of the crisis. The ongoing normalisation of the level of housing investment led of itself to some easing in the rates of change in 2018, which is expected to continue over the projection horizon. The combination of this moderation in the dynamism of investment in housing and the slight rise projected for the saving rate will lead household financing needs to stabilise at around 1% of GDP.

In line with the outlook for the continued expansion of activity, business investment is expected to remain notably dynamic. It will mirror the high degree of capacity utilisation, the availability of low-cost financing and the recent strengthening in firms' financial position. However, this aggregate will also move on a somewhat slowing path, in line with the easing in the increase in final demand, the progressive slackening of the need for added plant capacity and the setting of greater uncertainty stemming from rising trade tensions and from the failure to specify the timing and final configuration of Brexit. In any event, the notable vigour recently shown by this final demand component has led the increase anticipated for this aggregate over the forecasting horizon (and especially in 2019) to be revised upwards. That therefore offsets the unfavourable effect that the revision of the assumptions in the projection exercise (and, in particular, the prospect of less dynamic export markets) has on the outlook for business investment.

On the external front, there has recently been a notable loss of momentum in both exports and imports. Their respective growth rates were, in the opening months of the year, significantly down on those anticipated three months ago. This performance is related to

3 Specifically, the entry into force in September 2018 of the regulations on pollutant emissions gave rise to a decline, in the final stretch of the year, in car purchases, goods for whose acquisition a very high proportion of consumer credit is usually earmarked. Into the opening months of 2019, lending granted to households for purposes other than house purchase has continued to slow, despite the decline in car sales having eased.

the slowdown in global trade, which has been proportionately more acute than that in activity. Among other factors, this is related to the uncertainty added by the successive announcements of protectionist measures, which have in particular affected manufacturing activity and investment worldwide. Trade has been impaired, moreover, by the idiosyncratic difficulties affecting the car industry, which is characterised by the high degree of its participation in global value chains.[4] Beyond the short term, the dent to trade is reflected in the assumptions about the growth of Spanish export markets: compared with the March projections, the increase in these markets is now expected to be 0.9 pp lower in cumulative terms over the course of the projection horizon. The outcome is a downward revision of the pace of exports, one sharper in the short term. As the projection horizon unfurls, the baseline scenario of the projections is for exports to gather greater steam, assisted by the projected improvement in external markets.

The projections for imports maintain the assumption that their weight in final demand will stand at similar levels to those in recent years and lower, therefore, than the historical average. Moreover, this GDP component has also been revised downwards relative to March, in line with the weakness shown recently and with the lesser momentum of exports, a demand component with a high import content.

The gradual easing in output growth rates expected over the projection horizon will translate into a progressive reduction in the pace of job creation. Further, the effects of the rise in the minimum wage that came into force at the start of the year will tend to temper the buoyancy of employment in the coming quarters. In any event, the increase in employment will mean further reductions in the unemployment rate will continue to be observed, although such reductions will be mitigated by the projected rise in the labour force. The unemployment rate will fall to slightly below 12% at the end of the projection horizon, a similar figure to that forecast three months ago.

In 2018, the year-end general government deficit was 2.5% of GDP, 0.2 pp down on the March projection. The improvement was due to more dynamic revenue, and to some easing in investment expenditure. Under the assumptions used, described in Box 1, there will be a 0.1 pp correction in the budget deficit in 2019. That is largely the net outcome of a similar-scale improvement and worsening in the cyclical component and the structural component, respectively. In the two following years, a gradual correction of the deficit is projected, as a result of the favourable effects of the business cycle. The structural balance, meanwhile, will scarcely change, therefore remaining at very high levels.

**Prices and costs**

Over the course of the projection horizon, a rise in wage growth is expected compared with recent years. The related rates of increase will be over 2% in each of the three years of the projection horizon. This quickening in wages will be the outcome of the gradual reduction in cyclical slack in the labour market, the application of the recommendations of the Employment and Collective Bargaining Agreement for the three years from 2018 to 2020 and, in the short term, the rise in the national minimum wage. In a setting of still-low productivity growth, the greater increase in compensation per employee will translate into more marked rises in unit labour costs.

In terms of their impact on prices, the bigger increases in unit labour costs will be partly offset by the easing in inflationary pressures from abroad, measured by the import deflator,

4 See Box 5 ("The impact of the car slowdown from a global value chain perspective") in the "Quarterly report on the Spanish economy", in *Economic Bulletin* 2/2019.

reflecting the slightly declining path of oil prices. As a net result of both effects, an acceleration in core inflation – measured by the rate of change of the HICP excluding energy and food – is projected, from 1.1% in 2018 to 1.7% in 2021. The declining profile recently evidenced by the rate of change of the overall consumer price indicator will continue in the coming months. The predominant influence in this connection will be the behaviour of the energy component, whose rates will turn negative. As from the end of the year, the overall indicator will begin to rise, mirroring the core component. Accordingly, in annual average terms, HICP growth will slow by 0.6 pp in 2019 to 1.1%, and will rise by 0.2 pp in each of the two subsequent years.

Risks

The risks surrounding the baseline scenario for economic activity remain tilted to the downside, and their intensity has increased in recent months. The uncertainty stems above all from the external environment, where some of the risks highlighted in previous reports have now begun to materialise and to negatively affect the baseline scenario of the projections. Of note, in particular, is the possible adoption of new protectionist measures (which, as well as through other channels, would affect global trade by distorting the global value chains) or a heightening of geopolitical tensions, which might ultimately bear down adversely on global trade and business investment. A no-deal Brexit might also entail severe consequences for both the United Kingdom and the EU. An additional factor of risk arises from the doubts over the effectiveness of the stimulus packages in China, and their possible secondary effects in terms of exacerbating the imbalances in the Chinese economy. Lastly, it cannot be ruled out that the uncertainty over the future path of fiscal policy in Italy, whose impact has so far been confined to this country, will ultimately affect other euro area economies. In the domestic arena, the high degree of parliamentary fragmentation that has been in place for several years adds greater uncertainty over the future stance of economic policies and the adoption of reforms to boost the economy's growth potential.

As regards inflation, the risks of deviation from the baseline scenario are likewise predominantly tilted to the downside. This is as a result of two different types of factors. First, a hypothetical materialisation of the downside risks to activity that have been described would give rise to an easing in inflationary pressures (except, possibly, if new protectionist tensions were to arise in the form of higher tariff barriers). And second, the prospect of core inflation rising is conditional upon the assumption made about the scale of the response by inflation to the slack in the economy, with much uncertainty surrounding this assumption. In the opposite direction, a potential rise in geopolitical tensions would translate into higher oil prices and, as a result of this, into higher inflation rates.

7.6.2019.

The assumptions on interest rates and oil and other commodity prices are based on the prices quoted on the respective markets during the ten business days prior to the cut-off date (in this projection exercise, 15 May). In particular, the oil price is expected to average $68.1 per barrel in 2019, before falling quite sharply in the following two years, down to $62.7 in 2021 (see Table 1). Compared with the previous projections, this is a slightly upward revision, concentrated in the first two years of the projection horizon (3.3% in 2019 and 1.4% in 2020).[1]

In the case of interest rates, the 3-month Euribor is expected to remain, in annual average terms, at its 2018 levels (-0.3%) both in 2019 and 2020, before rising by 10 bp in 2021. In turn, 10-year government bond yields are expected to rise from 1.1% in 2019 to 1.6% in 2021. In consequence, the expected interest rate levels have been revised down (by between 0.1 pp and 0.2 pp, according to the year), both at the short and long end of the curve. Also, the cost of credit to households and corporations has been revised down slightly in the medium term, in keeping with the revised projections for short-term interest rates to which it is generally referenced.

1 The upward revision to the oil price assumptions, particularly at the start of the projection horizon, is related to the increase in crude oil prices in 2019 to date. This increase is fundamentally a result of supply factors, as explained in Box 1 ("The determinants of recent oil market developments") in the Quarterly Report on the Spanish economy, *Economic Bulletin* 2/2019.

The nominal effective exchange rate of the euro over the projection horizon, which according to the methodology used corresponds to the exchange rate traded on the forex spot markets prior to the assumptions cut-off date, is somewhat more depreciated (by around 1%) than in the previous projection exercise. The euro/dollar exchange rate is also slightly (some 2%) lower than it was three months ago.

The expectations for activity in the main geographical areas with which Spain trades, and for imports from those areas, are now less favourable – especially for 2020 – than was projected in March. This has prompted a small downward revision in the growth forecast for Spain's export markets, from 3% recorded in 2018 to 2.6% estimated for 2019, followed by a gradual increase to 3.2% in 2021.

The changes to the budgetary policy assumptions over the projection horizon are minor compared with the March projection exercise. On 1 January, as the draft State and Social Security Budget for 2019 had not been approved, the 2018 budget was automatically extended. This situation continued after Congress rejected the draft budget submitted by the Government in January. Thus, most budget items were frozen at the nominal 2018 levels, except for those affected by certain measures passed by Congress and that were included in the previous projection exercise.[2] The

2 The most significant of these measures, on account of their size, on the expenditure side were (i) the revaluation of pensions in 2019 in

Table 1
INTERNATIONAL ENVIRONMENT AND MONETARY AND FINANCIAL CONDITIONS (a)

Annual rates of change, unless otherwise indicated

| | | June 2019 projections | | | Differences between June and March 2019 projections (b) | | |
|---|---|---|---|---|---|---|---|
| | 2018 | 2019 | 2020 | 2021 | 2019 | 2020 | 2021 |
| International environment | | | | | | | |
| World output | 3.6 | 3.1 | 3.4 | 3.3 | -0.2 | 0.0 | 0.0 |
| Spain's export markets | 3.0 | 2.6 | 2.9 | 3.2 | -0.1 | -0.6 | -0.2 |
| Oil price in US dollar/barrel (level) | 71.1 | 68.1 | 65.8 | 62.7 | 3.3 | 1.4 | -0.1 |
| Monetary and financial conditions | | | | | | | |
| US dollar/euro exchange rate (level) | 1.18 | 1.12 | 1.12 | 1.12 | -0.01 | -0.02 | -0.02 |
| Nominal effective exchange rate against the non-euro area (c) (2000 = 100 and percentage differences) | 121.5 | 116.8 | 116.4 | 116.4 | -0.8 | -1.0 | -1.0 |
| Short-term interest rate (3-month EURIBOR) (d) | -0.3 | -0.3 | -0.3 | -0.2 | 0.0 | -0.1 | -0.2 |
| Long-term interest rate (10-year bond yield) (d) | 1.4 | 1.1 | 1.3 | 1.6 | -0.1 | -0.2 | -0.2 |

SOURCES: ECB and Banco de España.

a Assumptions cut-off date: 15 May 2019. The figures expressed as levels are annual averages; the figures expressed as rates are calculated based on the relevant annual averages.
b Differences are between rates in the case of world output and export markets, between levels in the case of oil prices and the dollar/euro exchange rate,percentage differences for the effective nominal exchange rate, and percentage point differences in the case of interest rates.
c A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.
d For the projection period, the figures in the table are technical assumptions, prepared using the Eurosystem's methodology. These assumptions are based on futures market prices or on proxies thereof and should not be interpreted as a Eurosystem prediction as to the course of these variables.

projections also include the regional and local government budgets approved for 2019, and the information available on the budget outturn. Regarding the assumptions for the rest of the projection horizon, on 30 April, in accordance with the European Semester schedule, the Government sent the 2019-2022 Stability Programme Update to the European Commission. This Update is based on the assumption of no new measures, with two exceptions: approval for 2020 of the revenue measures included in the State Budget that were not implemented, owing to it being rejected by Congress, and the measure to extend pension indexation to the CPI over the entire projection horizon. However, at the cut-off date for this projection exercise there is still uncertainty regarding the implementation of these measures and, therefore, in keeping with Eurosystem methodology, they are not included in the assumptions.

In this setting, as in the March projections, certain technical assumptions have been made to project the expected paths of some budgetary headings for the period 2020-21. First, it is assumed that the more discretionary budget items – particularly public investment and procurement, on account of their size – will evolve in line with the potential growth of the Spanish economy.[3] Second, in the absence of other measures, it is assumed that the trajectory of the other headings of the general government accounts will be governed by their usual determinants. Specifically it is assumed that public revenue will grow in line with tax bases, which mainly depend on the macroeconomic environment. Similar assumptions are made for less discretionary expenditure items. This is the case of pension expenditure (which is determined, together with the increases agreed for 2018-19, by the revaluation formula established by law and by population ageing), unemployment benefits (which mainly depend on how unemployment evolves) and interest payments (which are determined by changes in government debt levels and interest rates).

In accordance with these assumptions and projections for the budgetary policy variables, and the output gap estimated consistently with the other macroeconomic projections, the budgetary policy stance would be expansionary in 2019, before becoming approximately neutral in the following two years.[4]

accordance with forecast CPI, (ii) the increase in public sector wages, (iii) the gradual extension of paternity leave to eight weeks in 2019 and to 12 and 16 weeks, respectively, in the following two years, and (iv) the reinstatement of unemployment benefits for workers over 52 years of age. On the revenue side, the projections include the increases in the contribution bases: in the minimum contribution bases, owing to the increase in the national minimum wage; in the maximum contribution bases (+7%); and in the contribution bases for the self-employed.

3 In the specific case of public investment, the projected scenario includes the compensation to ACESA, the AP-7 toll motorway concession holder, for the cost of widening a section of the motorway (€585 million), in accordance with the Supreme Court ruling of March 2017.

4 In 2018 and 2019 certain one-off factors had a significant impact (such as the costs of the insolvent motorway companies, of the asset protection schemes and deferred tax assets of the banking sector, and of the court ruling stipulating that maternity and paternity benefits are exempt from personal income tax), amounting to the equivalent of 0.5% and 0.4% of GDP, respectively.